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BREAKING UP AND MAKING OUT (RICH): RECOMMENDATIONS FOR REVISION OF BANKRUPTCY CODE PROVISIONS GOVERNING BREAK-UP FEES USED BY STALKING HORSE BIDDERS IN § 363 BANKRUPTCY ASSET SALES

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I. INTRODUCTION & ISSUE

Since December 2007, the United States has suffered through a "Great Recession."[1] The stock market had plummeted more than 40% from its peak as investors pulled their money from investments seeking

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1. Chris Isidore, *The Great Recession*, CNNMONEY.COM, Mar. 25, 2009, http://money.cnn.com/2009/03/25/news/economy/depression_comparisons/index.htm. Although the recession is officially over per gross domestic product reports from the National Bureau of Economic Research, the economy by any other measure is still in recession with high unemployment, imminent tax increases, fragile financial institutions, and a substantial risk of a double-dip recession. *See* Michelle Singletary, *For Many of Us, the Recession Lives on*, WASH. POST, Sept. 23, 2010, at A22, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/09/22/AR2010092205546.html; Nouriel Roubini & Michael Moran, *Avoid the Double Dip*, FOREIGNPOLICY.COM, Nov. 2010, http://www.foreignpolicy.com/articles/2010/10/11/avoid_the_double_dip?print=yes&hidecomments=yes&page=full.

safety under their mattresses.[2] Companies and individuals have struggled as bankruptcy filings increased to 1,306,315 nationwide during the twelve-month period that ended on June 30, 2009—a 35% increase since the end of June 2008.[3] Americans' investment funds have not vanished, however, as funding sources wait on the sidelines ready to reinvest in America's future.[4] According to the Federal Reserve, Americans currently hold $8.85 trillion in cash, bank deposits, and money market funds.[5] This $8.85 trillion in liquid assets equals 74% of the market value of all U.S. companies, the highest ratio since 1990.[6]

America's economic recovery depends upon the quick and efficient reinvestment of this sidelined money back into corporate America by healthy corporations, individuals, and private equity funds.[7] An essential component of this recovery will be to encourage private equity funds back into the market by providing incentives to buy either the assets of or the entire bankrupt companies pursuant to § 363 of the United States Bankruptcy Code (bankruptcy code).[8] Section 363 authorizes debtors to "use, sell, or lease" their assets in "the ordinary course of business" and upon notice to stakeholders and with court approval, to do the same with those assets outside "the ordinary course of business."[9] Section 363 also provides the statutory framework for the sale of companies in bankruptcy.[10] The sale of companies under § 363 of the bankruptcy code comes with many advantages to the purchaser, including, among others, that such companies may leave bankruptcy

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2. Tom Paradis & Sara Lepro, *Stocks Fall on Belief Global Recession Is at Hand*, THE HUFFINGTON POST, Oct. 24, 2008, http://www.huffingtonpost.com/2008/10/24/stocks-head-for-sharp-dec_n_137438.html.

3. Frank Taylor, *Bankruptcy Filings Continue to Exceed 2008 Numbers Nationwide and in Houston*, EXAMINER.COM, Aug. 25, 2009, http://www.examiner.com/u-s-district-court-in-houston/bankruptcy-filings-continue-to-exceed-2008-numbers-nationwide-and-houston.

4. Eric Martin & Michael Tsang, *Cash at 18-Year High Makes Stocks a Buy at Leuthold*, BLOOMBERG.COM, Dec. 29, 2008, http://www.bloomberg.com/apps/news?pid=email_en&refer=&sid=aHYVLN8ZJtsc.

5. *Id.*; *see also* Alexandra Twin, *Stocks: $2.9 Trillion on the Sideline*, CNNMONEY.COM, May 16, 2010, http://money.cnn.com/2010/05/16/markets/individual_investors/index.htm?hpt=T2 (noting that individual investors have roughly $2.9 trillion in liquid investment readily available for possible investment in assets of or the entirety of bankruptcy companies).

6. Martin & Tsang, *supra* note 4.

7. *See* Isidore, *supra* note 1.

8. *See* 11 U.S.C. § 363(b)(1) (2006) (providing the procedure for the "[u]se, sale, or lease of property" outside the "ordinary course of business" that has entered the bankruptcy system); 11 U.S.C. § 1123(b)(4) (2006) (allowing for the sale of the bankrupt company with proceeds paid to the creditor of the bankrupt company).

9. *See* 11 U.S.C. § 363(b)(1).

10. *See* KEITH C. OWENS, FOLEY & LARDNER, ASSET PURCHASER'S GUIDE TO BANKRUPTCY SALES 1–2 (2003), *available at* http://www.foley.com/files/tbl_s31Publications/FileUpload137/1358/bankrupcy.623.2.pdf. In other instances, companies can also be sold through a Chapter 11 reorganization plan. *Id.* at 1; 11 U.S.C. § 1123(b)(4).

free and clear of any liens and are protected from fraudulent transfer claims.[11] In addition, break-up fees encourage private equity funds to venture into the bankruptcy court system and acquire bankrupt companies in whole or in part.[12]

A break-up fee "is an incentive payment to a prospective purchaser with which a company fails to consummate a transaction."[13] A stalking horse bidder is the "initial bidder with whom the debtor negotiates a purchase agreement."[14] In simpler terms, a break-up fee is a termination fee paid by the bankruptcy estate to the stalking horse bidder if "the proposed sale [is] not consummated through no fault of the [bidder]."[15] The break-up fee compensates the unsuccessful initial bidder through a fee greater than the initial bidder's actual due diligence expenses.[16] Bankrupt companies often find it difficult to acquire a stalking horse bidder because most bidders prefer to wait and simply bid over the stalking horse.[17] Stalking horse bidders rightly worry that their due diligence, and the significant expense it entails, will simply be used by either the bankruptcy estate to solicit higher offers or by subsequent bidders to simply bid over a well researched and now entrenched bidder.[18] Many times, debtors lure stalking horse bidders, who are hoping to buy the bankruptcy estate for pennies on the dollar, only to use them for higher bids and to maximize the value of the assets.[19]

To encourage the stalking horse bidder to set a floor for the auction price and terms of the transaction, a break-up fee is normally bargained for in the purchase agreement.[20] The stalking horse's bid helps to assure that the bankruptcy estate will be sold for the minimum acceptable bid.[21] The company, creditors, and trustee accepted the minimum acceptable bid when they executed the initial purchase agreement,

11. 11 U.S.C. § 363(f) ("The trustee may sell property . . . free and clear of any interest in such property . . . ."); *In re* Trans World Airlines, Inc., 322 F.3d 283, 290 (3d Cir. 2003); SHARON ALEXANDER, JONES DAY, BANKRUPTCY SALES: THE STALKING HORSE 1 (2003), *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S2177; OWENS, *supra* note 10, at 1–2.

12. ALEXANDER, *supra* note 11, at 2.

13. Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 653 (S.D.N.Y. 1992).

14. ALEXANDER, *supra* note 11, at 1.

15. OWENS, *supra* note 10, at 5; *see also* ALEXANDER, *supra* note 11, at 2.

16. *See* ALEXANDER, *supra* note 11, at 1.

17. *Id.* at 2.

18. *Id.* at 1.

19. John J. Jerome & Robert D. Drain, *Bankruptcy Court Is Newest Arena for M&A Action*, N.Y.L.J., June 3, 1991, at 1, 8.

20. *See* ALEXANDER, *supra* note 11, at 2.

21. Joseph Samet, *Use of Break-Up and Topping Fees in Corporate and Bankruptcy Asset Sales*, 906 PLI/COMM 1113, 1115–17 (2008).

before proceeding with the auction.[22] Many reasons exist for prospective purchasers to require break-up fees (essentially a windfall to the bidder) and for sellers to grant such fees (essentially a punitive cost to the bankruptcy estate).[23] However, break-up fees generate controversy because many argue they detract from the value of the estate by forcing other bidders to keep bids low to compensate for break-up fees.[24] Others argue break-up fees undercut the bankruptcy code's and the debtor's goals to preserve as much value for the estate and its creditors as possible.[25] This heated debate leads courts to adopt widely different standards and rules in governing the allowance of break-up fees.[26]

In general, bankruptcy courts require that the debtor establish that a tendered offer is the highest and best offer.[27] However, there is no federal statute or uniform common law standard for the allowance or denial of break-up fees.[28] Courts currently use three common standards to determine whether to allow for payment of a break-up fee to a stalking horse bidder in a § 363 asset sale.[29] However, none of these

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22. *Id.*

23. *Id.* at 1116.

> Potential purchasers will often require a break-up or topping fee as reimbursement or to compensate for: the continuing costs and risk that the stalking horse will be outbid for the assets in question . . . legal and professional fees and other expenses incurred obtaining financing commitments, completing legal due diligence and negotiating and drafting agreements with the seller; the time, energy and management resources incurred as a result of the attempted acquisition; and the opportunity costs of foregoing other business and investment opportunities while the bidding process unfolds.
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> . . . .
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> Sellers are willing to pay break-up and topping fees to encourage: initial "stalking horse" offers when there are no competing bidders; bidding strategies that avoid holding back competitive bids until later in the sale process; initial bids that may be the offeror's highest bid earlier in the sales process; a floor price early in the bidding process; and momentum towards the consummation of a sale.

Id.

24. Bruce A. Markell, *Case Against Break-up Fees in Bankruptcy*, 66 AM. BANKR. L.J. 349, 360 (1992).

25. Jerome & Drain, *supra* note 19, at 8.

26. *See generally* Samet, *supra* note 21, at 1117–25 (discussing the three different standards by which courts will determine the allowance of a break-up fee).

27. *In re* Atlanta Packaging Prods., Inc., 99 B.R. 124, 131 (Bankr. N.D. Ga. 1988) ("It is a well-established principle of bankruptcy law that the objective of bankruptcy sales . . . is to obtain the highest price or greatest overall benefit possible for the estate.").

28. *See* Samet, *supra* note 21, at 1117–25.

29. WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW & PRACTICE § 44:27 (3d ed. West 2010); David M. Holliday, *Right to Recover Break-Up Fee Arising from Sale of*

standards calls for detailed analysis of break-up fees or the effect of the break-up fees on the stakeholders of the estate.[30] The bankruptcy code is designed to give uniform and detailed processes for corporations and individuals within the bankruptcy system.[31] The lack of a uniform break-up fee standard encourages parties to forum shop,[32] and it results in a race to the bottom among companies, bidders, and courts vying for bankrupt companies.[33] Additionally, the lack of a uniform standard leaves stalking horse bidders guessing whether bankruptcy judges will approve or deny their break-up fees, producing erratic break-up fee negotiations and no initial bid floor for many § 363 asset sales.[34]

In order to address the harm caused by the lack of a uniform standard, this Note will argue that a new detailed, uniform statute be integrated into the bankruptcy code. First, such a statute will fulfill the ultimate goal of the bankruptcy code, to maximize for the estate the highest bid for the property.[35] Second, it will force bankruptcy courts to employ consistent procedures to ensure that bidders know that their bids will not be subject to unfair and unscrupulous practices.[36] Third, the statute will ensure that bankruptcy and district judges no longer issue arbitrary[37] and unpredictable decisions in complicated bankruptcy sale cases.[38] Lastly, it will discourage investment companies from forum

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Bankruptcy Estate Property, 39 A.L.R. FED. 2D 219, § 2 (West 2010).

30. *See* Holliday, *supra* note 29, §§ 2–11 (analyzing the different jurisdictional tests regarding break-up fees). Note, however, that the Business Judgment Rule only looks at whether the management acted in the best interest of the estate, avoiding the detailed analysis of the fee. The general administrative expense standard ignores the fees' effect on the bankruptcy estate. And the Best Interest of the Estate only requires a brief and bird's eye view of whether the fee is fiscally prudent for all stakeholders.

31. City of New York v. Quanta Res. Corp. (*In re* Quanta Res. Corp.), 739 F.2d 912, 915 (3d Cir. 1984) ("The objectives of federal bankruptcy law can be broadly stated: to provide for an equitable settling of creditors' accounts by usurping from the debtor his power to control the distribution of his assets.").

32. Scheinbart v. Certain-Teed Prods. Corp., 367 F. Supp 707, 710–11 (S.D.N.Y. 1973) ("The federal courts . . . have little sympathy for forum shopping. 'The federal courts comprise a single system applying a single body of law, and no litigant has a right to have the interpretation of one federal court rather than that of another determine his case.'" (quoting H. L. Green Co. v. MacMahon, 312 F.2d 650, 652 (2d Cir. 1962))).

33. *See generally* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 9–24 (2005) (noting that bankruptcy courts competing to encourage companies to file for bankruptcy in their jurisdiction have lowered their standards to lure in these lucrative cases).

34. Markell, *supra* note 24, at 353.

35. *Id.* at 350 n.5 ("'When the law requires a sale of property . . . to be made [at] public auction . . . it is for the purpose of inviting competition among bidders that the highest price may be obtained for what is sold[.]'" (quoting Porter v. Graves, 104 U.S. 171, 174 (1881))).

36. *Id.* at 359, 366.

37. *See* LOPUCKI, *supra* note 33, at 9–24.

38. *See* Markell, *supra* note 24, at 358–59, 375 (noting that bidders with knowledge that

shopping[39] and will create an efficient system for investments in bankrupt companies, producing greater economic value and wealth.[40]

Part II of this Note analyzes the current precedent applied by bankruptcy courts in determining the allowance of break-up fees.[41] Part II concludes that all three of the current break-up fee standards are problematic and insufficient.[42] Part III first analyzes the usefulness of break-up fees and their growing popularity in § 363 transactions.[43] Part III then recommends that a new uniform standard (referred to as the Best Interest of the Estate with Guidance Elements) be enacted into the bankruptcy code and applied uniformly nationwide by bankruptcy courts in determining the allowance of break-up fees.[44] Part IV concludes by highlighting the benefits of this new standard on § 363 transactions.[45]

II. CURRENT PRECEDENT FOR BREAK-UP FEES IN BANKRUPTCY

Currently, courts use three main standards to determine whether to allow a break-up fee to be paid to a stalking horse bidder in a § 363 sale: the Business Judgment Rule, the general administrative expense standard found in bankruptcy code § 503(b), and the Best Interest of the Estate standard.[46]

A. *Business Judgment Rule*

The Business Judgment Rule is a non-bankruptcy doctrine that courts normally apply in reviewing corporate transactions.[47] "The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in honest belief that the action taken was in the best interest of the company."[48] "The business judgment rule's presumption

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their deal will be reviewed by the courts will adjust their bids accordingly to compensate for the risk of denial of the break-up fee).

39. *See* LOPUCKI, *supra* note 33, at 9–24.

40. *See id.*

41. *See infra* Part II.

42. *Id.*

43. *See infra* Part III.A.

44. *See infra* Part III.B.

45. *See infra* Part IV.

46. Holliday, *supra* note 29, §§ 2–11 (discussing the three main standards and other standards, which are not addressed in this Note, but have been applied in rare instances).

47. Mark F. Hebbeln, *The Economic Case for Judicial Deference to Break-Up Fee Agreements in Bankruptcy*, 13 BANKR. DEV. J. 475, 475–76 (1997).

48. Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 656 (S.D.N.Y. 1992) (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985), *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009)) (internal quotation marks omitted).

shields corporate decision-makers and their decisions from judicial second-guessing when the following elements are present: '(1) a business decision, (2) disinterestedness, (3) due care, (4) good faith, and (5) according to some courts and commentators, no abuse of discretion or waste of corporate assets.'"[49] In utilizing the Business Judgment Rule, courts rarely interfere, question, or block a transaction barring evidence of gross negligence, fraud, bad faith, or self-dealing.[50] The Second Circuit most often applies the Business Judgment Rule to determine the allowance of break-up fees.[51] In this context, the court utilizes the Business Judgment Rule to determine whether the break-up fee bolsters the bidding process and serves the best interest of the seller's shareholders.[52] Unfortunately, this goal is rarely achieved.[53]

Courts began utilizing the Business Judgment Rule in § 363 bankruptcy asset sales to

> increase the number of bidders in bankruptcy by standardizing bidding practices in all business acquisitions . . . [as] bidders for troubled companies do not just operate in bankruptcy; indeed, their main focus and market is the non-bankruptcy arena. Having different rules in bankruptcy for what is essentially the same transaction only injects confusion into the process, and this confusion translates into lower bankruptcy dividends through reduced bids (to compensate for the confusion) or reduced competition (brought about by the confusion). By adopting the rules of the main game, courts hope that more bidders will consider bankruptcy debtors as acquisition candidates, and will bid more confidently for those debtors.[54]

Few courts, though, have addressed whether the Business Judgment Rule actually effectuates these goals in bankruptcy asset sales.[55] *In re*

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49. *Id.* (quoting DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE 12 (3d ed. 1991)).

50. *See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine* 5 (UCLA, Sch. of Law and Econ. Res. Paper Series, Res. Paper No. 03-18), *available at* http://ssrn.com/abstract=429260 (click the "One-Click Download" link; then select "Open" in the pop-up window) (arguing that the Business Judgment Rule is merely a doctrine of abstention that courts use as a justification to refuse to examine the board of directors' decision).

51. *See generally* AMERICAN COLLEGE OF BANKRUPTCY'S CIRCUIT REVIEW AND BEST PRACTICES REPORTS (2008) [hereinafter BEST PRACTICES REPORTS] (stating that the Business Judgment Rule is not the official, binding standard for the Second Circuit since only the district courts—and not the appellate court—has adopted the standard).

52. *See* Samet, *supra* note 21, at 1120–21 (construing *In re Integrated Res., Inc.*, 147 B.R. at 657).

53. *Id.*

54. Markell, *supra* note 24, at 359.

55. *See Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re*

Integrated Resources, Inc.[56] and *In re 995 Fifth Avenue Associates, L.P.*[57] lead the case law supporting utilization of the Business Judgment Rule in break-up fee cases. The District Court for the Southern District of New York in *In re Integrated Resources, Inc.* affirmed the bankruptcy court's decision to approve an $8.5 million break-up fee in the dissolution of a holding company, valued at $565 million.[58] The district court laid out a three-part test to determine when the Business Judgment Rule can be applied in a break-up fee case: "(1) is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation;[59] (2) does the fee hamper, rather than encourage, bidding;[60] (3) is the amount of the fee unreasonable relative to the proposed purchase price?"[61] In *In re Integrated Resources, Inc.*, the district court answered no to each of these three questions, affirming the bankruptcy court's ruling and holding that break-up fees were entitled to review under the Business Judgment Rule.[62] The court reasoned that the Business Judgment Rule "shields corporate decision-makers and their decisions from judicial second-guessing" when the five requirements of the Business Judgment Rule are present.[63] The court further reasoned that negotiation and agreement to a break-up fee is simply a contractual negotiation.[64]

Integrated Res., Inc.), 147 B.R. 650, 657 (S.D.N.Y. 1992).

56. *See id*.

57. 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989).

58. 147 B.R. at 653–55. The holding company, which was "complicated and not easily valued," failed to secure an initial bidder without the enticement of a break-up fee and expense reimbursements. *Id.* at 654.

59. *Id.* at 657. The court expounding upon part one of the test stated, "'Nowhere does the Code address this tension [between interested parties]. The courts balance these concerns on a case by case basis.'" *Id.* at 658–59 (quoting *In re* Crowthers McCall Pattern Inc., 114 B.R. 877, 881 (Bankr. S.D.N.Y. 1990)).

60. *Id.* at 657. The court expounding upon part two of the test stated:

> The appropriate question is whether the break-up fee served any of three possible useful functions: (1) to attract or retain a potentially successful bid, (2) to establish a bid standard or minimum for other bidders to follow, or (3) to attract additional bidders. Despite the confusing reference to a "stalking horse," the bankruptcy court correctly concluded that the Break-up Fee encouraged bidding, because BT served all three of the above functions.

Id. at 661–62.

61. *Id.* at 657. The court expounding upon part three of the test stated, "A break-up fee should constitute a fair and reasonable percentage of the proposed purchase price, and should be reasonably related to the risk, effort, and expenses of the prospective purchaser." *Id.* at 662.

62. *Id.* at 657–64. Even though the debtor's managers discussed with the initial bidder the prospects of retaining their executive positions after the buyout, the court still saw management as disinterested. *Id.* at 658.

63. *Id.* at 656.

64. *See id.* at 663.

The court in *In re American West Airlines* criticized the *In re Integrated Resources, Inc.* decision for failing to "carefully scrutinize" the necessity of the break-up fee or its helpfulness to the transaction. The court also disapproved of the seemingly blind application of the reasoning underlying the Business Judgment Rule in the non-bankruptcy context.[65] The court, in its opinion, "went as far as to recognize there exists a difference between acquisitions in bankruptcy and outside of bankruptcy,"[66] yet failed to show why the Business Judgment Rule should apply to § 363(b) cases or even discuss the precise procedural requirements of § 363(b).[67] In essence, rather than analyze whether the break-up fee was in the best interest of all the interested parties (secured creditors, management, directors, shareholders, etc.), helpful to the bidding process, or even appropriate under § 363(b), the court instead treated the break-up fee as a simple issue of corporate negotiation and contracting.[68]

In *In re 995 Fifth Avenue Associates, L.P.*, a $500,000 break-up fee for a stalking horse bidder's initial $62 million bid was approved by the bankruptcy court in the $76 million sale of a hotel in New York City.[69] The Bankruptcy Court for the Southern District of New York applied the Business Judgment Rule in its decision because the rule had "vitality by analogy" to break-up fee jurisprudence in the corporate context.[70] The court further reasoned that the Business Judgment Rule applies to both corporate and bankruptcy break-up fee jurisprudence because managers and directors owe the same fiduciary duty to creditors in both situations.[71] Given the management's stake in the outcome due to their equity ownership, the court in *In re 995 Fifth Avenue Associates, L.P.* failed to consider whether management, which had a stake in the outcome because of their equity ownership, acted truly disinterested or in the best interest of the creditors to whom they owed a fiduciary duty.[72]

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65. *In re* Am. W. Airlines, 166 B.R. 908, 911–12 (Bankr. D. Ariz. 1994) (holding also that the Business Judgment Rule should never apply to break-up fee jurisprudence as the sale of a business is always outside the normal course of business and requires greater judicial analysis).

66. *Id.* at 911–12.

67. *See id.* (noting that the *In re Integrated Resources, Inc.* court failed to address whether the debtor followed the correct post petition procedures under § 363(b), including gaining court approval for a prospective purchase agreement); *see also* 11 U.S.C. § 363(b) (2006) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business . . . .").

68. *See* Markell, *supra* note 24, at 358.

69. 96 B.R. 24, 25 (Bankr. S.D.N.Y. 1989). The break-up fee was awarded in part because of "[t]he spirited auction [which] was the direct result of a contract of sale by and between the debtor and [the stalking horse bidder] . . . ." *Id*.

70. *Id.* at 28. The Business Judgment Rule would not have applied if the fee was too large or chilled bidding. *Id.* at 28–29.

71. *Id.* at 28 n.4.

72. *See id.* at 28–29. The court failed to discuss whether the debtor company and its

The failure by the court in *In re 995 Fifth Avenue Associates, L.P.* and many other courts to adequately analyze the entire transaction and weigh each stakeholder's interests[73] highlights not only why the Business Judgment Rule is inappropriate in bankruptcy § 363(b) asset sales but also the need for a uniform detailed standard.[74] A debtor in possession that is offering a portion of its estate for sale merely to entice an initial bidder should have to prove that there is "some articulated business justification" or "good business reason" for approving a break-up fee under § 363(b) that would protect the interests of all stakeholders.[75] Neither the court in *In re Integrated Resources, Inc.* nor in *In re 995 Fifth Avenue Associates, L.P.* seemed concerned with whether the debtor in possession carried these burdens of proof or whether the break-up fee served the best interest of all stakeholders.[76] The courts, in using the Business Judgment Rule, failed to examine the necessity of break-up fees to the transaction or their usefulness to encourage a competitive bidding process.[77] Rather than carefully examining the transactions under § 363(b) with respect to all stakeholders, the courts deferred to the non-bankruptcy Business Judgment Rule without meaningful § 363(b) analysis.[78]

The major difficulty with application of the Business Judgment Rule in break-up fee jurisprudence is that it fails to take into account the motivational differences between a debtor in possession (management during bankruptcy proceedings) and a non-debtor (management in normal times).[79] The interests in bankruptcy differ from normal corporate action as "[s]hareholders tend to seek the long-term rehabilitation of the enterprise and to retain even those assets which make only a marginal contribution to profitability. [While b]ondholders . . . will often try to force the sale of profitable assets to generate cash quickly to pay their claims."[80] Due to the adverse interests of equity holders and debt holders, management faces a conflict of interest and

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management fulfilled the six requirements of the Business Judgment Rule before applying the Rule and merely assumed that since there had been scrutiny by a few stakeholders, the Rule was applicable. *Id.*; *see also* Myron M. Sheinfeld & Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 BUS. LAW. 79, 88 (2004) ("Some courts hold that directors' fiduciary duty shifts from the stockholders to the creditors when a company becomes insolvent . . . .").

73. *See* 96 B.R. at 28–29.

74. Samet, *supra* note 21, at 1121–22 (providing a thorough discussion of the rejection of the Business Judgment Rule).

75. Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 772 F.2d 1063, 1070–71 (2d Cir. 1983).

76. Samet, *supra* note 21, at 1119–21; Markell, *supra* note 24, at 360 & n.53.

77. Samet, *supra* note 21, at 1119–22.

78. *Id.*

79. Markell, *supra* note 24, at 358.

80. Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 659 (S.D.N.Y. 1992).

thus fails the disinterested requirement of the Business Judgment Rule.[81] "In the non-bankruptcy takeover cases, management's fiduciary duties run primarily to the corporation's shareholders . . . [while] the management of a bankrupt company must 'further the diverse interests of the debtor, creditors and equity holders, alike.'"[82] Therefore, management must try to balance its fiduciary duty to the estate to seek out the best offer it can for the relevant stakeholders against its incentive to craft the purchase agreement to the personal, financial benefit of equity stakeholders, including itself.[83]

Management's conflict of interest and the diverse interests of the many stakeholders in bankruptcy weaken any case for the application of the Business Judgment Rule in § 363(b) sales.[84] Stalking horse bidders need certainty that their due diligence and bargained for break-up fees will be upheld in court.[85] Because company management in bankruptcy has a conflict of interest, the non-bankruptcy Business Judgment Rule is ineffective and should no longer be boot-strapped into bankruptcy.[86] Strict application of the rule would cause companies to fail every time.[87] Therefore, the Business Judgment Rule ought to be inapplicable to break-up fees in bankruptcy cases.[88] The complications of bankruptcy require the courts to conduct a more thorough detailed analysis for every case.[89] Thus, a new uniform and detailed standard, with higher scrutiny than the judicial deference to the Business Judgment Rule, is needed to give guidance to courts, debtors, attorneys, and creditors in the bankruptcy process.[90]

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81. Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) ("A director is interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders.").

82. *In re Integrated Res., Inc.*, 147 B.R. at 658; Sheinfeld & Pippitt, *supra* note 72, at 88 ("Some courts hold that directors' fiduciary duty shifts from the stockholders to the creditors when a company becomes insolvent . . . .").

83. NORTON, *supra* note 29, § 44:28.

84. *In re* Crowthers McCall Pattern, Inc., 114 B.R. 877, 881 (Bankr. S.D.N.Y. 1990).

85. Markell, *supra* note 24, at 365-66.

86. *In re* Am. W. Airlines, Inc., 166 B.R. 908, 911–12 (Bankr. D. Ariz. 1994); *In re* Hupp Indus., Inc., 140 B.R. 191, 193–94 (Bankr. N.D. Ohio 1992).

> In the context of a nonbankruptcy asset sale, . . . break-up fees are presumptively appropriate in view of the Business Judgment Rule . . . . In the bankruptcy context, however, the Court must be necessarily wary of any potential detrimental effect that an allowance of such a fee would visit upon the debtor's estate.

Id.

87. *See In re Am. W. Airlines, Inc*., 166 B.R. at 913; *In re Hupp Indus., Inc.*, 140 B.R. at 195–96.

88. *In re Am. W. Airlines, Inc*., 166 B.R. at 912–13; *In re Hupp Indus., Inc.*, 140 B.R. at 194.

89. *In re Am. W. Airlines, Inc.*, 166 B.R. at 912–13.

90. Hebbeln, *supra* note 47, at 507–08 ("[C]ourts' practice of invalidating break-up fee agreements . . . provide[s] a disincentive to the initial bidder, a result that all would agree is not

B. *General Administrative Expense Jurisprudence of § 503(b)*

In considering the allowance of break-up fees, the second standard used by bankruptcy courts arises out of the administrative expense jurisprudence of § 503(b) of the bankruptcy code.[91] Administrative expenses are debts of the estate which are paid after all secured debts are fully repaid but before any unsecured debts are satisfied.[92] There are nine different circumstances in which courts, after notice and hearing to all stakeholders, can declare an unpaid and unsecured debt an administrative expense.[93] Since administrative debts take priority over all other unsecured debt, every debtor and stakeholder strives to convince the courts to declare their debts an administrative expense to help secure full repayment.[94]

The Third Circuit Court of Appeals, which is the only circuit that applies a uniform standard for determining the allowance of break-up fees, utilizes administrative expense jurisprudence to analyze break-up fees.[95] In *In re O'Brien Environmental Energy, Inc.*, the Third Circuit rejected both the Best Interest of the Estate standard and the Business Judgment Rule as proper procedures for determining the allowance of break-up fees.[96] After discussion and analysis of both alternative standards, the court held that "none . . . offers a compelling justification for treating an application for break-up fees and expenses under § 503(b) differently from other applications for administrative expenses under the same provision."[97] The court further rejected adopting the detailed, nine factor analysis used by the lower bankruptcy court.[98] Instead, the Third Circuit adopted only the lower court's "implicit" conclusion that the award of the break-up fee was unnecessary and stated that all break-up fee analysis should stem directly and solely from § 503(b)(1)(a).[99] Without conducting a thorough analysis, the court held that stalking horse bidders were simply required to prove that the break-

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desirable.").

91. NORTON, *supra* note 29, § 44:27; *see generally* 11 U.S.C. § 503(b) (2006) (allowing for administrative expenses which include the "actual, necessary costs and expenses of preserving the estate").

92. 11 U.S.C. § 503(b) (describing the nine different reasons courts can allow for payment of administrative expenses); 11 U.S.C. § 506 (2006) ("[d]etermination of secured status"); 11 U.S.C. § 507 (2006) ("[p]riorities" of unsecured claims including administrative expenses); 11 U.S.C. § 726 (2006) ("[d]istribution of property of the estate" upon liquidation).

93. 11 U.S.C. § 503(b); 11 U.S.C. § 507.

94. 11 U.S.C. § 503(b); 11 U.S.C. § 507.

95. BEST PRACTICES REPORTS, *supra* note 51.

96. 181 F.3d 527, 535 (3d. Cir. 1999); NORTON, *supra* note 29, § 44:30.

97. *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d at 535.

98. *Id.* at 536 ("§ 503(b)(1)(A), which requires that an expense provide some benefit to the debtor's estate.").

99. *Id.*

up fees "were actually necessary to preserve the value of the estate."[100] In *In re American Appliance*, the Bankruptcy Court for the District of New Jersey expanded upon *In re O' Brien Environmental Energy, Inc.* The court rejected a break-up fee by refusing to characterize the fee as necessary to preserve the value of the estate if it advantaged a favored purchaser or where a potential purchaser would bid, whether or not break-up fees were offered.[101]

Although it was a valiant effort by the Third Circuit to give a new (and arguably better) standard, the application of administrative expense jurisprudence in break-up fee cases leaves stalking horse bidders still guessing whether or not their break-up fee will be approved and has initiated little change in practice.[102] The § 503(b) standard, although also preferred by the First, Fourth, and Eighth Circuits over the Business Judgment Rule, exceedingly fails to give guidance through administrative expense reimbursement precedent, without regard to the relationship, similarities, or most importantly, the glaring differences between administrative expenses and break-up fees.[103] Break-up fees and § 503(b) administrative expenses differ primarily in that administrative expenses are supposed to be reimbursements or repayments to legislatively preferred and designated creditors, while break-up fees are often excessive damages paid to outside and non-invested bidders who lose a later auction or fail to consummate a purchase agreement for some reason other than the fault of the stalking horse bidder.[104] The Bankruptcy Court for the Northern District of Ohio, in *In re Hupp Industries, Inc.*, explained that "[a] break-up fee should not be authorized as an administrative expense where it is ill-defined, not correlated to an actual transactional cost or expense incurred by the negotiating bidder, and otherwise cannot be addressed under a specific provision of § 503(b)."[105]

The first step Congress should take to reform break-up fee jurisprudence and give concrete guidance for bidders is to recognize the

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100. *Id.* at 535 (allowing break-up fees if it was proven that the presence of a break-up fee promoted competitive bidding, thereby raising the estate's auction price).

101. *In re* Amer. Appliance, 272 B.R. 587, 601 (Bankr. D.N.J. 2002).

102. David Peress & Stewart L. Cohen, *Breaking Up Is Hard to Do*, AM. BANKR. INST. J., Feb. 2001, at 25.

> Since *O'Brien*, little has apparently changed in the Third Circuit. Buyers of assets continue to routinely insist upon and receive various forms of bid protections, including break-up fees. . . . Nevertheless, and notwithstanding the Third Circuit's admonition that break-up fees must be necessary "to preserve the value of the estate," it remains business as usual.

Id.

103. BEST PRACTICES REPORTS, *supra* note 51; Samet, *supra* note 21, at 1122–24.

104. 11 U.S.C. § 503(b) (2006); ALEXANDER, *supra* note 11, at 2.

105. 140 B.R. 191, 196 (Bankr. N.D. Ohio 1992).

difference between compensatory administrative expenses and excessive break-up fees.[106] The problem with the § 503(b) standard is that most courts do not recognize that treating break-up fees as administrative expense reimbursements is similar to treating compensatory and non-compensatory damages the same in a breach of contract dispute.[107] Break-up fees are penalties, above and beyond any actual due diligence costs, paid by companies in bankruptcy who fail to consummate a purchase agreement.[108] The failure to distinguish between compensatory and non-compensatory payments not only violates basic contract law, which would apply to the asset purchase agreement,[109] but it also violates § 503(b) by providing liquidated windfall damages to stalking horse bidders when the statute clearly only allows for compensatory reimbursement under nine specific situations, which all deal with expenses that are "actual" and "necessary" to preserving the value of or properly dispensing the estate.[110]

C. *Best Interest of Estate*

As a third alternative, bankruptcy courts use the Best Interest of the Estate standard in reviewing the allowance of break-up fees.[111] The Best Interest of the Estate standard was adopted by some bankruptcy courts as a response to the inadequacy of the Business Judgment Rule.[112] The Best Interest Standard applies a broad analysis that aims to ensure the highest sale price for the asset.[113] The Best Interest Standard primarily differs from the Business Judgment Rule in that the former takes into account the economic impact upon all interested parties and stakeholders, including creditors, thereby addressing the fiduciary duty conflict faced by management in addressing divergent interests in bankruptcy proceedings.[114] The Best Interest Standard is most often

106. *Compare infra* Part III, *with In re* Beth Israel Hosp. Ass'n of Passaic, No. 06-16186, 2007 WL 2049881, at *12–14 (Bankr. D.N.J. July 12, 2007) (applying the same standard as would be applied to any administrative reimbursement expense under § 503(b)).

107. Barnes v. Gorman, 536 U.S. 181, 187 (2002) ("[P]unitive damages, unlike compensatory damages and injunctions, are generally not available for breach of contract . . . ."); *see In re Beth Israel Hosp. Ass'n of Passaic*, 2007 WL 2049881 at *12–14 (rejecting argument that the break-up fee can be treated as liquidated punitive damages).

108. Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 653 (S.D.N.Y. 1992).

109. 3 RESTATEMENT (SECOND) OF CONTRACTS § 355 (1979); NORTON, *supra* note 29; 22 AM. JUR. 2D *Damages* § 574 (2003) ("Punitive damages are generally not available under a contract theory. Specifically, courts generally hold as a general rule that punitive damages are not available as a remedy for breach of contract, without an underlying tort.").

110. 11 U.S.C. § 503(b) (2006).

111. NORTON, *supra* note 29, § 44:29.

112. Samet, *supra* note 21, at 1121–22.

113. *Id.* at 1115–17.

114. *See id.* at 1119–21.

applied by bankruptcy courts in the Sixth and Ninth Circuits in reviewing break-up fees.[115]

The Second Circuit formulated the Best Interest Standard in *In re Lionel Corp.*, in which the court considered whether to allow a break-up fee in the dissolution of a toy train manufacturer.[116] The court instructed judges to consider "all salient factors" relating to the stakeholders affected by the bankruptcy proceeding when evaluating break-up fees.[117] *In re Lionel Corp.* served as the founding basis for the Best Interest Standard, as judges for the first time were instructed to look beyond the transaction itself and its business sense and focus on the break-up fees' impact upon the estate and its stakeholder.[118]

The Bankruptcy Court for the District of Arizona applied the Best Interest Standard during the complex and contentious bankruptcy dissolution case of America West Airlines, which involved multiple creditors, bidders, and stakeholders.[119] The Chapter 11 debtor entered into an interim sale procedure agreement that provided for a break-up fee of $4 million to $8 million to the stalking horse bidder if the purchase agreement failed to consummate.[120] After careful analysis of the entire potential transaction, including the economic impact on all stakeholders, the court in *In re America West Airlines, Inc.* rejected the break-up fee provision as not being in the "best interest [of the] estate."[121] In denying the proposed break-up fee provision, the court chose to apply the Best Interest Standard instead of the Business Judgment Rule, stating that "the standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will further the diverse interests of the debtor, creditors and equity holders, alike."[122] The court reasoned that "[t]he analysis conducted by the Court [in break-up fee cases] must . . . include a determination that *all* aspects of the transaction are in the best interests of all concerned."[123]

Although the Best Interest Standard is the best of the three existing standards due to its requirement that the impact of the break-up fee be evaluated in the light of all stakeholders, the standard needs specific factors or elements to guide judges and attorneys in their evaluation of

115. BEST PRACTICES REPORTS, *supra* note 51.

116. Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1065–66 (2d Cir. 1983).

117. *Id.* at 1071.

118. Samet, *supra* note 21, at 1121.

119. *In re* Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994).

120. *Id.* at 910.

121. *Id.* at 913.

122. *Id.* at 912 (quoting Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir.1983)) (internal quotation marks omitted).

123. *Id.*

break-up fees.[124] Although the *In re Lionel Corp.* court pioneered the Best Interest Standard by instructing judges to consider the impact of the break-up fee upon all stakeholders, it failed to provide judges with definite factors to help guide judges in their evaluation.[125] The court in *In re Hupp Industries, Inc.* filled this void by being the first to clearly articulate factors to be used as guidelines in break-up fee cases.[126] The court stated that seven factors must be considered when determining "the propriety of allowing break-up fee[s]."[127] Although these factors were a good start to guide courts, they are not binding as would be clearly defined elements in a new section of the bankruptcy code.[128]

III. Analysis and Recommendation for New Uniform Standard to Evaluate Break-Up Fees in Bankruptcy § 363 Asset Sales

Before recommending a new uniform standard to evaluate break-up fees in bankruptcy asset sales, I will analyze the usefulness of break-up fees. For clarity, it should be kept in mind that break-up fees consist of two elements: the portion that reimburses potential buyers for their actual due diligence expenses and the portion paid to potential buyers above their actual due diligence expenses.[129] It is critical that courts

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124. *See In re Lionel Corp.*, 722 F.2d at 1071.

125. *See id*.

126. *In re* Hupp Indus., Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

127. *Id.*

> 1) Whether the fee requested correlates with a maximization of value to the debtor's estate;
> 2) Whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and the negotiating acquirer;
> 3) Whether the principal secured creditors and the official creditors committee are supportive of the concession;
> 4) Whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price;
> 5) Whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders;
> 6) The existence of available safeguards beneficial to the debtor's estate;
> 7) Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee.

Id.

128. *See* 11 U.S.C. § 103 (2006); 11 U.S.C. § 105(a) (2006) ("The court may issue any order . . . that is necessary or appropriate to carry out the provisions of this title."). A mandatory "element" is defined as "[a] constituent part of a claim that must be proved for the claim to succeed," as opposed to a guidance "factor," which is defined as "[a]n agent or cause that contributes to a particular result." BLACK'S LAW DICTIONARY 599, 630 (8th ed. 2004).

129. *In re* Tropea, 352 B.R. 766, 768 (Bankr. N.D.W. Va. 2006) (distinguishing between actual expenses incurred by the stalking horse bidder and a punitive finder's fee that was

distinguish and rule separately on actual expense reimbursement provisions and the portion of break-up fees that is in excess of actual due diligence expenses.[130] The Bankruptcy Court for the Northern District of West Virginia made this distinction clear in *In re Tropea* when it held that even though a stalking horse bidder was entitled to "actual, necessary costs and expenses[,]" it was not entitled to a "liquidated percentage fee."[131] The court properly separated the two provisions,[132] analyzing actual expenses under the actual and necessary to preserving the estate § 503(b)(1) standard of the bankruptcy code while analyzing the excess portion of the break-up fee under a stricter (yet not fully defined) standard.[133] Because break-up fee provisions are liquidated damages clauses,[134] they should be analyzed under a stricter standard before courts allow an initial bidder in a bankruptcy § 363(b) sale to receive a windfall.[135] Conversely, the bankruptcy estate's actual due diligence expenses should be held to the more relaxed actual and necessary for costs preserving the estate standard.[136]

A. *Are Break-Up Fees Necessary or Useful?*

Two key questions must be answered in analyzing whether break-up fees are necessary or useful in § 363(b) asset sales. First, who should bear the cost of investigating the potential subject asset of an auction?[137] Second, do initial bidders need inducement or incentive to place bids for companies in bankruptcy?[138] These questions focus on a common scenario: a debtor, with its conflicted fiduciary interests, agrees to a break-up fee with a potential bidder; its creditors and stakeholders are

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characterized as a break-up fee).

130. *In re* Hupp Indus., Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

> It is observed that some courts have considered the allowance of break-up fees in various forms. One court considered such fees framed solely in the form of expense reimbursement for out-of-pocket expenses relating to costs incurred during a due diligence period, while another court allowed reasonable break-up fees wholly independent of the transaction costs.

Id. (citing *Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.)*, 135 B.R. 746, 752–53 (Bankr. S.D.N.Y. 1992); *In re* 995 Fifth Ave. Assocs., 96 B.R. 24, 29 n.6 (Bankr. S.D.N.Y. 1989)).

131. *In re Tropea*, 352 B.R. at 768.

132. *See In re Hupp Indus., Inc*., 140 B.R. at 194.

133. *In re Tropea*, 352 B.R. at 768–69.

134. TINA L. STARK, NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE § 9.03(3) (2003).

135. *See* 11 U.S.C. § 503(b)(1)(A) (2006); *In re* Beth Israel Hosp. Ass'n of Passaic, No. 06-16186, 2007 WL 2049881, at *15–16 (Bankr. D.N.J. July 12, 2007).

136. *See supra* note 135.

137. *In re* S.N.A. Nut Co., 186 B.R. 98, 106 (Bankr. N.D. Ill. 1995).

138. *See id.*

forced to pay for the break-up fee without a fair say in the matter; and the initial bidder receives all the benefit with little or no risk.[139]

On one hand, break-up fees encourage competitive bidding by compensating initial bidders for their risk, due diligence expense, time and energy, and the lost opportunity cost of not focusing on or acquiring other potential takeover targets.[140] Initial bidders argue that they need the encouragement and protection of break-up fees since they expect their bids to be shopped around by the bankrupt company to achieve the highest price for the asset.[141] "The last thing a bidder wants is to have its offer 'shopped' or used as a stalking horse for other bids."[142] Yet this stalking horse bid is exactly what the bankruptcy estate wants and needs to fulfill fiduciary duties: an initial competitive bid not only to set the floor of the auction but also to solicit other potential suitors in order to get the highest auction price.[143]

On the other hand, break-up fees are many times excessive, give little benefit to the final value of the asset, and discourage later bidders in the auction.[144] Initial bidders also need little incentive to offer early bids, as they would most likely bid anyway, considering the strong benefits and protection that bankruptcy provides for buyers of assets.[145] Initial bidders argue that they need this compensation in order to justify researching and bidding for risky bankrupt companies.[146] However, this argument pales against the many advantages the bankruptcy code provides to buyers of assets in bankruptcy.[147] In fact, many companies are placed into bankruptcy at the request of bidders in order to secure these substantial benefits found in no other context.[148]

Break-up fees also disadvantage later bidders by increasing the amount that later bidders must offer in order to place a competitive bid.[149] For "if [the sum of] the bid costs [including the break-up fee] and

139. *Id.* at 106 (noting that creditors and other stakeholders end up paying for the break-up fee in the form of fewer assets available for distribution since a break-up fee must be paid out from the final auction price).

140. Samet, *supra* note 21, at 1115.

141. Markell, *supra* note 24, at 357.

142. *Id.* at 365.

143. *Id.*

144. *See id.* at 369.

145. *See* 11 U.S.C. § 363(f) (2006); Markell, *supra* note 24, at 374.

146. *See* Markell, *supra* note 24, at 374–75, 380; ALEXANDER, *supra* note 11, at 1.

147. Markell, *supra* note 24, at 374–75.

148. *See id*. at 374. Bidders in negotiating asset sale agreements will sometimes require the target to file for bankruptcy protection as a condition of the agreement. *See id.* (construing *In re* Financial News Network, Inc. 126 B.R. 152, 154 (S.D.N.Y. 1991)). The bankruptcy code also encourages this practice by allowing pre-petition solicitations of votes to approve a Chapter 11 plan, which are binding post-petition, assuming compliance with applicable disclosure laws and regulations. 11 U.S.C. § 1126(b) (2006).

149. *See* Markell, *supra* note 24, at 362–63.

the bid price exceed the estimated value of the asset, then the bidder will not proceed," forcing out many potential bidders from the auction.[150] Break-up fees can also fund research into competitor's non-public records.[151] In this sense, bidders not only get a free look at their competitor's books, but bidders may also receive windfall compensation for doing so.[152]

The Bankruptcy Court for the Northern District of Illinois in *In re S.N.A. Nut Company* recognized the quandary of the two questions noted above and succinctly stated,

> The goal of a bankruptcy auction . . . is to maximize the return to the estate. The cost of bidding should be borne by those who are best able to bear them—the bidders who have voluntarily entered the bidding process, and who are bidding for a company with title free and clear of liens and with all the advantages provided by the Bankruptcy Code.[153]

Although the debate over the usefulness of break-up fees continues, courts have implicitly accepted break-up fees without much analysis,[154] as being a normal and necessary part of corporate and bankruptcy asset sales.[155] Courts now approve break-up fees with greater frequency, leaving more creditors and stakeholders holding the break-up fee bill.[156] Bruce Markell was correct in concluding that the "trend [of courts] towards adoption and approval of these [break-up fees]" is ill-advised.[157] The case law makes it appear that break-up fees are not

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150. *Id.* at 362. In simple math, if a company is willing to bid as high as $10 for a company, but there is a $2 break-up fee provision, economics dictate that the company will leave the auction at $8, thereby limiting bidders and reducing the final auction value of the asset. *Id.*

151. *Id.* at 361 n.57 ("[I]f the potential acquirer is a competitor of the target. . . . there are potential concerns regarding antitrust violations or unfair trade practices—the bidder may mount a sham bid simply to acquire non-public information regarding the debtor.").

152. *Id.* at 361–62.

153. *In re* S.N.A. Nut Co., 186 B.R. 98, 106 (Bankr. N.D. Ill. 1995) (rejecting the application of the Business Judgment Rule and instead applying the Best Interest Standard).

154. *See supra* Part II.

155. ALEXANDER, *supra* note 11, at 1–2.

156. Markell, *supra* note 24, at 351.

157. *Id.* at 351, 369.

> [T]he maximum breakup fee that a court should approve is one that offers to repay a bidder's direct costs of preparing and making its bid. Any additional fee will overcompensate the bidder for its risk in bidding; it pays the bidder for bidding when it would have bid without the fee. . . . It is wasteful, and should be discouraged. The actual court reaction to such requests for breakup fees, however, has not followed this course.

going away anytime soon.[158] Therefore, a new uniform standard must be introduced to help make the process fair, guided, and balanced.[159]

B. *Recommendation for New Uniform Standard—Best Interest of the Estate with Guidance Elements*

To remedy the absence of a uniform, detailed break-up fee standard, this Note argues that the following elements should be incorporated into § 363 of the bankruptcy code to govern the allowance of break-up fee provisions.[160] These elements should be incorporated as guidance against the backdrop of the existing Best Interest of the Estate Rule[161] that already instructs judges to take into account the economic impact upon all stakeholders while analyzing the fiduciary duty conflict faced by management.[162]

The first guidance element in analyzing the justification for a break-up fee is whether the stalking horse bidder will share its due diligence with later bidders.[163] Stalking horse bidders primarily require break-up fees to keep later bidders from using their initial bids and due diligence as a platform to make subsequent bids.[164] In an effort to maximize information among all bidders and reduce duplication of due diligence, stalking horse bidders should be encouraged to share their due diligence. While the sharing of due diligence cannot eliminate all duplication,[165] it provides courts with a solid justification to grant the stalking horse bidder a break-up fee in compensation for lowering the total cost of due diligence among all bidders.[166] In satisfying this first element, stalking horse bidders should offer evidence to the court that they will share their due diligence and that such sharing will encourage other bidders.[167]

Id. at 369.

158. *Id.* at 351, 369.

159. *See id.*

160. *See* LOPUCKI, *supra* note 33, at 19–20 (noting that many bankruptcy judges desire to attract the biggest cases to their courtroom in an effort to gain notoriety, respect in the legal and business community, and most importantly ensure they are elected to a second term, sometimes at the expense of nationwide uniform decision-making).

161. Samet, *supra* note 21, at 1121–22. Defining a mandatory "element" as "[a] constituent part of a claim that must be proved for the claim to succeed," as opposed to a guidance "factor" defined as "[a]n agent or cause that contributes to a particular result." BLACK'S LAW DICTIONARY 559, 630 (8th ed. 2004).

162. *See supra* note 161.

163. Markell, *supra* note 24, at 379.

164. Although later bidders will rarely see the stalking horse's due diligence, they can easily bid incrementally above the initial bid knowing that the stalking horse bidder would not place an irrational bid. *Id.* at 377–78.

165. *Id.* at 361 (noting that "[a]s useful as such information is, the bidder must spend some of its funds to obtain it" and verify that the information is correct and not misleading).

166. *Id.* at 370.

167. Evidenced in the form of subsequent bidders who vouch that they would not have bid

The second guidance element in analyzing the justification for a break-up fee should be whether the break-up fee will hamper an auction process or discourage further bidding.[168] Inflated break-up fees may hinder competing bids by making them too expensive.[169] If the court finds that the break-up fee is a reason why later bidders might likely choose not to bid and raise the value of the asset, it should view with great suspicion the break-up fee in relation to the best interests of the estate.[170] It can be difficult for a court to discern the real reason why a potential later bidder might choose not to bid.[171]

In such cases, courts should be entitled to require that a competitive auction occur in order for a break-up fee to be awarded.[172] Generally, no reasons exist to pay a break-up fee if the auction fails to produce multiple bidders or the purchase agreement fails for reasons other than a subsequent bidder outbidding the stalking horse bidder for the asset.[173] On the other hand, a successful competitive auction that "will serve to maximize revenue[s]" among well-researched and informed bidders gives support for the reasonableness of the break-up fee if the initial bidder is fairly outbid.[174]

The third guidance element supporting a stalking horse bidder's claim to a break-up fee should be whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and the negotiating bidder.[175] Courts should examine whether the initial bidder held any leverage in the asset purchase agreement negotiation and/or forced the debtor into the break-up fee provision.[176] Courts should possibly consider whether the initial bidder held any undue leverage by applying the fair dealing factors of the entire fairness standard which is commonly used in analyzing non-bankruptcy corporate transactions.[177] By evaluating "[how] the transaction was

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but for the initial bid and the information it supplied them. *See id.* at 370, 379.

168. *See* Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 657 (S.D.N.Y. 1992); *In re* Hupp Indus. Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

169. Markell, *supra* note 24, at 362 ("This is shorthand for a traditional cost/benefit analysis: if [the sum of] the bid costs and the bid price exceed the estimated value of the asset, then the bidder will not proceed.").

170. *See id.* at 366.

171. *See id.* at 360.

172. *Id.* at 367–68.

173. *Id*. at 368.

174. *Id*. at 367–68.

175. *See In re* Hupp Indus. Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

176. *Id.*

177. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) ("[F]air dealing . . . embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.").

timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained," the court will more thoroughly understand the bargaining powers that each party had at the negotiating table.[178] Ultimately, a competitive bidding process with many potential initial bidders indicates that the debtor had many suitors with which it could negotiate favorable terms.[179] On the contrary, an asset sale with only one or two potential initial bidders would render a break-up fee suspect of unfair leverage in the asset purchase agreement negotiation.[180]

The fourth guidance element should be whether the stalking horse bidder was an insider or fiduciary of the debtor.[181] The court should consistently deny a break-up fee to insiders or fiduciaries of the debtor unless the bidder can prove that the fee in no way stymied the auction process and was critical to the initial purchase agreement.[182] If the debtor can prove these elements, the court should still assume that the insider or fiduciary had an inside track on due diligence and consider lowering the amount of the break-up fee to reflect this initial competitive advantage against other bidders.[183] This element would prevent fiduciaries from bartering away a piece of the company in which other interested parties have an interest and then claiming an excessive break-up fee.[184]

The fifth guidance element should be whether the debtor company is still run by old (pre-bankruptcy) management.[185] If so, then the company should have to prove "some articulated business justification" or "good business reason" with independent financial analysis to keep the pre-bankruptcy management.[186] Since no markets exists for courts to easily analyze the value of bankrupt assets, bankruptcy courts are deprived of such information and must rely on often self-serving statements of management as to its efforts to sell the asset. [187] In order to overcome the taint of self-interestedness, management must prove

178. *Id.*

179. *See In re* Hupp Indus. Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

180. *Id.*

181. *See* 11 U.S.C. § 101(31) (2006); *In re* Biderman Indus., Inc., 203 B.R. 547, 551–54 (Bankr. S.D.N.Y. 1997) (denying a break-up fee to fiduciary insider under the Business Judgment Rule for lacking disinterestedness).

182. *In re Biderman Indus., Inc.*, 203 B.R. at 551–54.

183. *See id.*

184. *See id.* at 553–54; Sheinfeld & Pippitt, *supra* note 72, at 88 ("Some courts hold that directors' fiduciary duty shifts from the stockholders to the creditors when a company becomes insolvent . . . .").

185. *See* 11 U.S.C. § 1107 (2006); Samet, *supra* note 21, at 1121–22 (thorough discussion of the rejection of the Business Judgment Rule).

186. Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 772 F.2d 1063, 1070–71 (2d Cir. 1983).

187. Markell, *supra* note 24, at 373.

this "good business reason" rather than simply presenting mere self-serving statements.[188] Courts additionally could question whether management used "good business reason[ing]" by applying the fair price factors of the entire fairness standard.[189] By evaluating the "economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock," the court could better evaluate whether management has utilized "good business reasoning."[190]

The sixth guidance element supporting a stalking horse bidder's claim to a break-up fee should require evidence that a stalking horse bidder would refrain from bidding if there was no break-up fee.[191] If another bidder can prove to the court that they would have bid without the incentive of a break-up fee, then the benefit of a break-up fee is greatly diminished.[192] On the other hand, if the debtor can prove that no bidders would bid without the protection of a break-up fee, then the break-up fee becomes a very useful tool to auction off the estate to the highest bidder.[193] Such proof may be scarce because, as one commentator put it, "[a]ll a court typically has before it when deciding to approve a breakup fee is the [stalking horse] bidder's self-serving [and post-auction] statement[s] that it [would not have gone] forward in the absence of a fee."[194] Courts generally have no sure way to fully test this type of statement.[195]

In considering whether the break-up fee discourages an auction process and precludes further bidding, the court should also examine whether the break-up fee constitutes a fair and reasonable percentage of the proposed purchase price.[196] Courts tend to approve break-up fees totaling between 1% and 4% of the total purchase price, but the higher the percentage, the more scrutiny the court should apply in examining whether the break-up fee is within the Best Interest of the Estate.[197]

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188. *See In re Lionel Corp.*, 772 F.2d at 1070–71; Markell, *supra* note 24, at 373.

189. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) ("[F]air price . . . relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.").

190. *Id.*

191. *See* Markell, *supra* note 24, at 360.

192. *See id.*

193. *See supra* note 35 and accompanying text.

194. Markell, *supra* note 24, at 360.

195. *Id.*

196. *In re* Hupp Indus. Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

197. *In re* Tampa Beef Packing, Inc., 312 B.R. 192, 194–95 (Bankr. N.D. Iowa 2004) (noting that in unusual or very large transactions the norm is 1% to 2% of the total purchase price); *cf.* Debra I. Grassgreen et al., *Who Wins in the Race to Get Break-up Fees Approved?* AM. BANKR. INST. J., Oct. 2003, at 52. (noting that fees equaling 2% to 3% of the proposed sale

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IV. CONCLUSION

The Best Interest of the Estate Rule, along with the aforementioned elements, should be incorporated by Congress into the bankruptcy code to help ensure that bankruptcy assets are sold for the highest possible bid[198] and that bankruptcy courts will apply consistent standards to break-up fees so that bidders can be more confident that their bids will not be subject to unfair and unscrupulous practices.[199] The new code provision will also help to avoid arbitrary[200] and unpredictable decisions by judges in complicated bankruptcy sale cases that mainly result from the current break-up fee jurisprudence.[201] The new code provision would discourage stalking horse bidders from forum shopping since the same rules would be effective in all districts.[202] Finally, and most importantly, the new code provision will create a more efficient system of investments in bankrupt companies facilitating the free flow of trillions of dollars currently waiting on the sidelines, in turn producing greater value, wealth, and long-term strength in the economy while preventing unworthy, initial stalking horse bidders from breaking-up and making out (rich).[203]

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price will generally be approved).

198. *See supra* note 35 and accompanying text.

199. *Id.* at 366.

200. *See* LOPUCKI, *supra* note 33, at 19–20 (noting that many bankruptcy judges desire attracting the biggest cases to their courtroom in an effort to gain notoriety, respect in the legal and business community and most importantly ensure they are elected to a second term).

201. *See* Markell, *supra* note 24, at 375 (noting that bidders with knowledge that their deal will be reviewed by the courts will adjust their bids accordingly to compensate for the additional risk associated with the non-uniform rules and possible rejection of the break-up fee).

202. *See generally* LOPUCKI, *supra* note 33 (noting that there is flexibility in the bankruptcy code exercised by bankruptcy judges in an effort to attract the biggest cases (and biggest fees) to their courtrooms).

203. *See* Isidore, *supra* note 1; LOPUCKI, *supra* note 33, at 19–20; Martin & Tsang, *supra* note 4 (noting that large-scale cash on the sidelines is a buy indication for equities in the near-term).